Internal Revenue Service

memorandum

CC:TL:Br2
SJHankin

date: FEB 12 1988

to: District Counsel, Manhattan CC:MAN

from: Director, Tax Litigation Division CC:TL

subject: [redacted]

This is to supplement the previous memorandum sent to your office regarding convertible debentures and to respond to your request for clarification of the position to be taken by the Government in the above-mentioned case and thereby enable you to provide the Justice Department with a letter to supplement the defense letter, dated August 8, 1985, previously provided to the Department of Justice with respect to this case.

ISSUE

Whether plaintiffs are entitled to deductions for losses incurred on the redemption of convertible debenture for the taxable years [redacted], [redacted], [redacted], and [redacted].

DISCUSSION

As a preliminary consideration we must define the issues we believe are properly before the court. The plaintiffs have contended in both their refund claims and complaints for all the tax years in question that the Commissioner improperly disallowed the plaintiffs a deduction for the capital losses sustained by [redacted] as the holder of certain debentures issued by various [redacted] subsidiaries (or their predecessors) upon the retirement of such debentures by the respective issuing companies (or their successors). All such losses were clearly computed by [redacted] by subtracting [redacted]'s (as distinguished from any of its subsidiaries) tax basis in the debentures from the principal amount (that being the amount paid or argued by [redacted] as having been deemed paid by the subsidiaries in redemption of the so-called "converted" debentures.) The point is that the plaintiffs have not claimed in any of their refund claims or in any of their complaints any tax losses attributable to the subsidiaries (the issuing companies or successors of the issuing companies) which resulted from the redemption of these so-called "converted" debentures. 1/ Accordingly, any subsequent attempt by the plaintiffs in this lawsuit to claim such losses at the subsidiary level with respect to the convertible debentures should not be considered by the court because of the defense of variance.

Treas. Reg. § 301.6402-2(b)(1) requires that a refund claim must set forth in detail each ground upon which a credit or refund is claimed and facts sufficient to apprise the Commissioner of the exact basis thereof. See, Forward Communications Corp. v. U.S., 608 F.2d 485 (Ct. Cl. 1979). Accordingly, pursuant to section 7422(a), the district court would have no jurisdiction to consider an issue in this refund suit with respect to subsidiary losses, because such an issue was not adequately raised in a timely filed refund claim.

Accordingly, the only issue currently before the court is whether [redacted] was entitled to loss deductions from the redemption by its subsidiaries of the so-called "converted" debentures. This issue was previously considered in [redacted]. The Tax Court in that case determined that no loss was realized by [redacted] on the retirement of its subsidiaries' debentures based on its interpretation of Treas. Reg. § 1.1502-41A(b). That is, the Tax Court held that the basis of the debentures to [redacted] (the parent) is deemed to be the purchase price paid by the Subsidiaries ([redacted] and [redacted]). Accordingly, since the amount [redacted] received on the redemption of the debentures was deemed to be equal to its basis, the Court held that no loss was realized by [redacted] on the retirement of the debentures. As a result, the Tax Court held that the real issue was the tax consequences to [redacted] and [redacted] on retirement of the debentures. The Tax Court after allowing [redacted] to reopen the record to establish [redacted]'s and [redacted]'s issue prices for the debentures held that [redacted] and [redacted] sustained ordinary losses on the retirement of the debentures. These losses at the subsidiary level were, however, made possible only by the application of Treas. Reg. § 1.1.502-41A, since the Court held that that regulatory provision caused the amount paid by the [redacted] subsidiaries to retire those convertible debentures to be treated as equal to [redacted]'s basis in the debentures. That is, Treas. Reg. § 1.1502-41A(b)'s deemed purchase price rule provided [redacted] with a deemed amount it was considered to have received on retirement of the debentures. Since under

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1/ Such losses, if allowable, would be computed by subtracting the amount paid or deemed paid by the subsidiaries-obligors from the adjusted issue price of the debentures.

that rule [redacted] was treated as receiving an amount for the debentures equal to its basis therein, [redacted] had no loss. That rule also provided the [redacted] subsidiaries with a deemed amount paid to redeem the debentures which was in excess of their issue price of the debentures, thereby assuring a loss to the subsidiaries.

Beginning after 1965, the Treasury promulgated a completely revised set of regulations for taxable years beginning after 1965. Such revised regulations do not contain a regulation like the one upon which the Tax Court premised its prior holding, Treas. Reg. § 1.1502-41A(b) or any adaptation closely analogous to it. Treas. Reg. § 1.1502-14(d) now provides the rules with respect to gains and losses on obligations of members. It provides:

> To the extent gain or loss is recognized under the Code to a member during a consolidated return year because of a sale or other disposition (<u>other than a redemption or cancellation</u>) of an obligation of another member..., whether or not such obligation is evidenced by a security, such gain or loss shall be deferred. (emphasis supplied)

The above deferral provision specifically excludes a redemption of an obligation of another member. We thus conclude that no consolidated return regulation has any impact on the redemption of the convertible debentures at issue in this case.

The argument that should be advanced in this case for precluding [redacted] from taking a loss on the retirement of the debentures is a <u>capital contribution</u> argument. That is, when [redacted] issued its stock to satisfy the debenture holder's right to convert the convertible debentures into stock that conversion resulted in a capital contribution to the [redacted] subsidiaries in the amount of the excess of the fair market value of the [redacted] stock issued in the conversion over any amount reimbursed to [redacted] by its subsidiaries or (if the convertible debentures are considered as continuing in the hands of [redacted] after conversion as "converted" debenture) over the value of the so-called "converted" debentures. Although the transactions in question can be conceptualized under at least five different characterizations, all of the characterizations are subject to the capital contribution argument. See, memoranda, dated Nov. 18, 1987 and December 3, 1987. Once [redacted]'s conversion of the debentures into [redacted] stock is recognized as effecting, in part, a capital contribution, [redacted]s subsequent retirement of the "converted" debentures for their principal face amount will generate no loss to [redacted], because its basis in the debentures will thus be reduced to the extent of the capital contribution.

With respect to the instant case, during the years [redacted] through [redacted], inclusive, holders of convertible subordinated debentures (which had originally been issued by four companies- [redacted], [redacted], [redacted] and [redacted]) converted varying amounts of the debentures into [redacted] stock following [redacted]'s acquisition of these companies in a tax-free reorganization. The conversion into [redacted] stock was in accordance with Supplementary Indenture Agreements executed in connection with [redacted]'s acquisition of the aforementioned companies. In particular, the Supplemental Indentures provided that [redacted] would assume the conversion obligation of the outstanding debentures. The basic debt obligation of the debentures was to be assumed by the wholly-owned subsidiaries [redacted] created to acquire the target companies. In addition, for the taxable years [redacted] through [redacted] inclusive debentures issued by two [redacted] subsidiaries, [redacted] and [redacted] were converted by [redacted] into [redacted] stock pursuant to the terms of certain debentures that had been executed by the particular parties.

Under all the above transactions, [redacted] became obligated to exchange [redacted] stock for debentures outstanding if so requested by the debenture holders. Since [redacted]'s conversion obligation only arose if the holder exercised his conversion right, since the conversion right was not certain to be exercised, and since the conversion obligation was not considered the primary 2/ obligation stemming from a convertible debenture, such assumption by [redacted] of the conversion obligation constitutes the assumption by [redacted] of a contingent obligation. It is clear in all the reorganization transactions that [redacted] did not buy the debentures at issue. It simply facilitated the reorganizations by agreeing, at the time the section 368(a)(1)(c) asset acquisitions were effected, to assume contingent obligations in the event the conversion privileges were exercised. This was done to aid its subsidiaries in making the acquisitions. Accordingly, the conversions all result in a capital contribution to the subsidiaries to the extent that the value of [redacted] stock given up in the conversion was more than the value [redacted] received (whether that value be received from the debenture holder or from [redacted]'s subsidiary). The holder's conversion of the debentures into [redacted] stock effectively discharged the subsidiaries from the obligations they had assumed to the holders. Therefore, [redacted]'s assumption of these obligations should properly be regarded as a contribution to the capital of the subsidiaries involved.

2/ The primary obligation stemming from a convertible debenture is a debt obligation. Chock Full O'Nuts Corp. v. United States, 453 F.2d 300 (2d Cir. 1971).

Meinhan v. Commissioner, 79 F.2d 324 (2nd Cir. 1935) cert. denied 296 U.S. 651 (1935). For further discussion, see original defense letter, dated August 8, 1985.

New Loan Approach

As is explained in the memorandum, dated November 18, 1987, when [redacted] issued its stock in conversion of the debentures, we believe that the preferred approach would be to treat the debentures as having been fully extinguished and to the extent the old debentures are stated to continue after the conversion as obligations of an [redacted] subsidiary to [redacted] those obligations (the so called "converted" debentures) should be treated as new obligations owing from the subsidiary to [redacted] (in an amount equal to the face value of the old debentures).

[redacted] should be treated as assuming the subsidiaries' full liability for the convertible debenture obligations, at the point in time that [redacted] issued its stock in satisfaction of the debenture holders' conversion rights. To the extent that the value of the old convertible (unconverted) debenture obligations to be assumed (as measured by the fair market value of the [redacted] stock issued in the conversion) exceeds the fair market value of the new debt such excess amount is a capital contribution by [redacted] to its subsidiary. [redacted]'s allocated cost basis in the new debt under section 1012 of the Code would be the fair market value of the old convertible (unconverted) debentures less the amount treated as a capital contribution. Under this characterization [redacted]'s basis in the new obligations would be less than the fair market value of all the [redacted] stock issued in the conversion, because part of the consideration conveyed to the subsidiary was not consideration for the new debt, but rather was a capital contribution by [redacted] to its subsidiary. This capital-contribution, new-debt analysis construction prevents [redacted] from building an artificial loss into the basis of the "converted" debentures held by [redacted]. The above is consistent with the third approach, set forth in the Memorandum, dated November 18, 1987.

We believe the "new loan" approach is the approach most consistent with the nature of a convertible debenture -- as being an indivisible obligation under which a satisfaction of the conversion right effects a total satisfaction of the entire debenture obligation. Yet, no court has given any indication that it might adopt the "new loan" approach.

The Tax Court has previously recognized a "converted" debenture concept i.e. that the parent corporation issues its stock pursuant to the conversion right of a debenture holder and by such conversion acquires the debenture devoid of its conversion rights. Husky Oil Company v. Commissioner, 83 T.C.

717 (1984); Honeywell Inc. and Subsidiaries v. Commissioner, 87 T.C. 624 (1986). This "converted" debenture characterization is also susceptible to the Government's capital-contribution argument. [redacted] upon issuing its stock in satisfaction of the debenture holders' conversion rights is viewed as having acquired "converted" debentures (debentures devoid of conversion rights). Under this characterization when [redacted] is called upon to satisfy the debenture holder's conversion right it should be argued to have assumed its subsidiary's conversion obligation, while the subsidiary remains liable to [redacted] on the debenture obligation (the "converted" debenture). This assumption of the conversion obligation represents a capital contribution by [redacted] to its subsidiary in an amount equal to the excess of the total value of the [redacted] stock transferred on conversion to the holder over the principal value of the debenture.

Although the Government advanced the capital contribution argument in the earlier [redacted] Tax Court case it only made such argument to the Tax Court as part a motion for reconsideration. Such argument was also made to the Second Circuit, but to no avail since the Second Circuit merely affirmed the Tax Court's holding by relying on the rationale set forth by the Tax Court in its opinion.

We believe that since Treas. Reg. § 1.1502-14A(b) is not applicable to the transactions at issue, the Court will be compelled in the instant case to consider the Government's capital contribution theory.

Collateral Estoppel

The plaintiffs allege that the defendant (the United States) is collaterally estopped from relitigating this issue by reason of the decision rendered in [redacted]. We continue to believe that collateral estoppel does not apply in this case, because the applicable tax rules have changed. The Tax Court premised its holding in the prior proceeding on Treas. Reg. § 1.1502-41A(b). Such regulation is not applicable to the years in the present proceeding. See, defense letter, dated [redacted].

SUBSIDIARY LOSS

The problem of a loss on redemption at the subsidiary level upon redemption of the debentures, as set forth in our memorandum of November 18, 1987, is not at issue in this case. The possible argument for such loss has never been advanced by [redacted] in this proceeding or in the prior proceeding. The loss to the subsidiaries permitted by the Tax Court in the prior proceeding was solely attributable to Treas. Reg. § 1.1502-41A(b) and was not based on the theory set forth in our previous memoranda. Any attempt by [redacted] to advance such a theory in the instant proceeding (which we have no reason at this point to expect that [redacted] would so argue) can be precluded from judicial consideration by the Government advancing a variance argument.

In the event, that [redacted] attempts to amend its complaint to claim losses at the subsidiary level under the theory set forth in the memorandum, dated November 18, 1987 and prevails over our variance defense, please seek our views at that time as to the proper theory to argue for disallowance of such losses.

SUMMARY

To summarize, the Government should advance a capital contribution argument to preclude the losses by [redacted]. This argument can be adapted either to our "new loan" approach or to a "converted" debenture approach. Under either characterization, the Government should argue that [redacted] has assumed the conversion obligation of its subsidiaries and in doing so has made contributions to the capital of its subsidiaries. Collateral estoppel should not prevent the Government from advancing its capital contribution theory, because the applicable tax rules have changed. The Government need not advance any theories for disallowance of losses at the subsidiary level, because no such losses have been claimed by the taxpayer, and a variance defense should preclude [redacted] from subsequently advancing such a contention.

Accordingly, we are continuing to recommend defense of the convertible debenture issue on the same general basis, set forth in the defense letter, dated [redacted].

MARLENE GROSS

By: ______________________
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